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UNCLAS SECTION 01 OF 05 BUENOS AIRES 000232

SENSITIVE
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E.O. 12958: N/A
TAGS: EFIN ECON EINV ETRD ELAB EAIR AR
SUBJECT: ARGENTINA ECONOMIC AND FINANCIAL REVIEW, FEBRUARY 16 - 27, 2009

¶1. (U) Provided below is Embassy Buenos Aires' Economic and Financial Review covering the period February 16-27, 2009. The unclassified email version of this report includes tables and charts tracking Argentine economic developments. Contact Econoff Chris Landberg at landbergca@state.gov to be included on the email distribution list. This document is sensitive but unclassified. It should not be disseminated outside of USG channels or in any public forum without the written concurrence of the originator. It should not be posted on the internet.

## Highlights

-- GoA achieves 80% participation rate in its PG swap
-- GoA reduces 2009 financial needs by about ARP 7 billion
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-- Argentina downgraded from "emerging" to "frontier" market
-- BCRA may end 2009 in the red for first time in six years
-- New allegations re INDEC manipulation of official statistics
-- INDEC surprises, announcing 4.4% y-o-y decline in January industrial production
-- FIEL foresees tough year for the Argentine economy in 2009
-- Disappointing January primary fiscal surplus raises concerns on future performance
-- Provincial Fiscal Accounts deteriorate in 2008; worse expected in 2009

## FINANCE

### GoA achieves 80% participation rate in its PG swap

¶2. (SBU) Argentine Chief of Cabinet Sergio Massa announced February 27 that the second phase (or so-called "international tranche") of the debt swap of Prestamos Garantizados (PGs, or "Guaranteed Loans") achieved a 42% participation rate out of the ARP 8.5 billion (US$ 2.43 bn) total eligible debt. PG holders tendered ARP 3.5 billion worth of loans in exchange for a peso-denominated bond, the Bonar, due in 2014, which carries a 15.4% fixed coupon for the first year and a Badlar variable rate plus a spread of 2.75% for the following four. (Note: Badlar is the average interest rate for deposits larger than ARP 1 million.)

¶3. (SBU) In its statements to the press, Massa noted that the GoA achieved an overall 80% participation rate in the PG debt swap, when taking into account both local and international phases of the transaction. (The first -- or local -- tranche

of the swap opened about January 22 and closed January 28.) PG holders tendered ARP 19.1 billion in the swap, out of a total of ARP23.8 billion (US$ 6.8 bn) in "eligible" PGs. (The swap covered four types of PGs, representing about 50% of total outstanding.) The local phase of the PG swap achieved nearly a 100% participation rate. Most analysts viewed these GoA liability management transactions as strongly positive for Argentina, as they eased GoA financial needs in 2009 by about ARP 7 billion (US$ 2bn). According to Credit Suisse, the swap results in the postponement of about ARP 18 billion (US$ 5.15 bn) in debt obligations originally due 2009 - 2011.

Argentina downgraded from "emerging" to "frontier" market
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¶4. (SBU) MSCI Barra equity index provider announced February 18 that it will reclassify Argentina as a frontier market, a downgrade from its previous classification as an emerging market. The change will enter into effect at the end of May, coinciding with MSCI Barra's publication of the May 2009 Semi-Annual Index Review. MSCI based the decision on the GoA and Argentine Central Bank's (BCRA) continued restrictions on inflows and outflows of capital to equity markets. MSCI Barra will consider only Argentine companies with American Depositary Receipt (ADR) listings as eligible securities for inclusion in its Index.

¶5. (SBU) Private analysts have been expecting this downgrade for the past four to five months. They point out, therefore, that the market has already discounted the change and the official announcement will not have much impact. Moreover,



most trading is carried out by domestic investors, who will not be swayed by this news. (Note: Frontier markets, which include Sri Lanka, Vietnam, Lebanon and Kazakhstan, are smaller and considered riskier than emerging markets and not sufficiently developed to be eligible for MSCI Barra's emerging markets index.)

BCRA may end 2009 in the red for first time in six years
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¶6. (SBU) Prefinex Consulting (an Argentine economic consulting company) predicted in a recent report that the Argentine Central Bank's (BCRA) financial result (known as the "quasi-fiscal" balance) may turn negative in 2009 for the first time since 2002. The quasi-fiscal balance is the difference between what a central bank earns on its assets and pays on its liabilities. In this case, it is the difference between the interest the BCRA earns on official reserves (mainly invested in U.S. and European Treasury bonds) and the interest the BCRA pays on its peso-denominated liabilities, mainly Lebacs and Nobacs (BCRA letters and notes).

¶7. (SBU) In its base-case scenario, Prefinex estimates that the BCRA will end 2009 with a deficit of ARP 3.1 billion, compared to an estimated surplus of ARP 680 million in 2008 (no more updated number), due to the increasing rate differential between U.S. Treasuries and BCRA instruments. (Prefinex expects Argentine interest rates to rise during 2009 as the BCRA and local banks attempt to prevent deposit withdrawals, while at the same time Treasury yields are nearing zero.) However, Prefinex analysts point out that further peso depreciation could mitigate this trend somewhat. (Depreciation reduces the expected BCRA quasi-fiscal deficit by increasing the value of foreign currency reserves measured in terms of pesos. As of February 20, BCRA reserves totaled ARP 166 billion, or US$ 47 bn, while outstanding Lebacs and Nobacs totaled ARP 38 billion.) As a result, avoiding a quasi-fiscal deficit is one argument in favor of allowing the peso to continue depreciating (the other arguments are to improve competitiveness and increase GoA tax collection). It is important to note that the GoA is one of the beneficiaries

of a strong BCRA balance sheet, because each year the BCRA transfers a portion of its annual earnings to the GoA Treasury, boosting the GoA fiscal surplus. Note: the peso is currently trading at 3.58 - 3.62 ARP/USD and most analysts expect it to depreciate to about 4.00 ARP/USD by the end of ¶2009.

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MACRO OUTLOOK
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New allegations re INDEC manipulation of official statistics
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¶8. (SBU) Economists from the well-known economic consulting firm Latin-Source recently alleged that the statistical manipulation that started in early 2007 with tampering of the CPI has now extended to other indicators. They noted that national statistics agency INDEC's release of preliminary GDP figures indicated growth of 4% y-o-y in Q IV, with annual growth of 7% y-o-y. This estimate contrasts sharply with most analysts' view that the economy expanded at a much slower pace during the year. Latin-Source estimates growth for the entire year at only 4%, following a sharp contraction in Q IV. Analysts note that the manipulation is so blatant that other statistical measurements, e.g., shopping mall and supermarket sales, do not square with the GDP estimates. One anecdotal example cited is cement production, which usually tracks closely with overall economic activity, but has recently completed divorced its trend from that of GDP growth. Another example is that the Latin America Research Foundation FIEL's privately calculated production index (the IPI), which decreased 7.4% in Q IV 2008, completely diverges from the INDEC production index (EMI), which increased 2.4% for the same period. (Note: INDEC surprised with a better estimate for January 2009; see next item.)

¶9. (SBU) In protest of the "poor quality and statistical anomalies observed in various indicators produced by INDEC," FIEL announced February 24 that it will limit its participation in the BCRA's market consensus survey (the REM). FIEL will no longer provide forecasts for five of the twenty-three economic variables included in the survey: CPI,



industrial production index (EMI), monthly economic activity index (EMAE), GDP, and unemployment. (Note: The Central Bank survey gathers data from fifty-seven economic forecasters including banks, brokerages, consultancies, think tanks and universities.)

¶10. (SBU) Subsequent to FIEL statement, local consulting firms Prefinex and Delphos Investment also announced that they would reduce their participation in the BCRA survey. Both said they would cease estimating the variables they believe INDEC has distorted. Other prominent consulting companies, including Abeceb.com, RSH Consulting, and Economia and Regiones, also stated that they are reviewing internally whether to continue participating in the BCRA survey, while Castiglione, Tiscorni and Asociados noted that they ended their participation over a year ago. In general, analysts who participate in the survey acknowledge that their goal for the BCRA survey is to estimate what INDEC will announce, while separately providing "true" economic estimates to their clients.

INDEC surprises, announcing 4.4% y-o-y decline in January industrial production
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¶11. (SBU) INDEC surprised most analysts February 23, announcing that industrial production (the EMI) declined 4.4% y-o-y in January, compared to the BCRA consensus survey's negligible decrease of 0.2%. As noted in the previous item, the BCRA survey represents the private sector predictions of INDEC reports, not the "true" estimates they provide clients

-- which in this case were still much larger than INDEC's estimate. For example: FIEL issued its own industrial production index (the IPI), in which it estimated a decrease of 11.4% y-o-y. Prominent Argentine economist Orlando Ferreres meanwhile estimated a drop of 9.1% y-o-y for the same period. INDEC explains that the fall in industrial production -- the first officially reported year-on-year decline since October 2002 -- was due to plunging automobile, steel, tires, and textiles output. Some optimistic analysts interpreted INDEC's January EMI estimate as a positive indication that the GoA is trying to bring the data more in line with reality.

FIEL foresees tough year for the Argentine economy in 2009
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¶12. (SBU) This item outlines the main points and alternative scenarios from FIEL's monthly presentation. (Buenos Aires-based Latin American Economic Foundation, FIEL, is a highly regarded independent Argentine think-tank devoted to economic and social research on Argentina and Latin America). FIEL Macro Overview:

-- GDP: FIEL estimates that GDP declined 1.5 - 2% y-o-y in QIV 2008, similar to other private analysts' estimates, but in sharp contrast to INDEC's official preliminary estimate of a 4.9% y-o-y expansion in QIV. FIEL estimates that GDP will contract 2% in 2009.

-- Inflation: FIEL estimates that inflation increased 1.7% m-o-m in January, compared to the official INDEC increase of only 0.5%. FIEL predicts inflation will end 2009 in the range of 15%, decelerating from 2008 inflation, which FIEL estimates was about 20-21%.

-- Confidence indicators are deteriorating rapidly, as reflected in Torcuato di Tella University and Fundacion Capital's indexes. However, FIEL notes that confidence levels are still not as low as they were prior to the 2001-2002 crisis. (Note: The established and reputable index of leading indicators that di Tella publishes shows that the economy is now flirting with a recession. The index is constructed along the same lines of the U.S. Conference Board index and provides signals about turning points in activity. In the January reading, the index dropped 20.6% y-o-y and has now recorded thirteen consecutive months of y-o-y declines. On a m-o-m basis the index dropped 1.3% from December, the eighth monthly drop during the last year.)

-- Banking System: Deposits recovered sharply in recent months, after a tough year that saw two mini-crises devastate the financial system (the March-July Agricultural conflict and October-November panic provoked by the worsening of the international financial crisis and the GoA's nationalization



of private pension funds). Banks are highly liquid and are not facing any run on deposits. However, they are reluctant to lend, and loans to the private sector are declining.

-- Fiscal: Tax revenues performed poorly in January, increasing only 11% y-o-y, with export and import taxes falling 27% y-o-y, the Financial Transactions Tax (FTT) dropping by 7% y-o-y and the income tax flat. (These calculations are in nominal terms, and the decline is more severe when accounting for inflation.) The sharp deceleration of the economy is reflected in the fall of FTT and VAT tax collections in real terms (when deflated with "true" CPI). Import tax revenues have also fallen sharply, as imports have fallen along with decelerating growth. Export tax revenue has been hard hit by lower commodity prices, lower export volumes (due to lower world demand), reduced sales resulting from the ongoing drought, and farmers efforts to withhold crop sales in protest of GoA agricultural policies. According to the 2009 Budget, the GoA assumed that tax revenues and expenditures would each increase by 15% in

nominal terms, resulting in a primary fiscal surplus of US$ 11.5 billion (3.6% of GDP). However, FIEL predicts that the GoA will have difficulty controlling expenditure growth in the run up to the October 2009 mid-term elections, and also expects revenues to continue to decelerate sharply in the coming months. FIEL, therefore, estimates the primary fiscal surplus will end 2009 at US$ 8.1 billion (2.5% of GDP).

-- Capital Flight: according to BCRA data, capital flight decelerated from previous months to US$800-900 million in January. If capital flight during 2009 is maintained at that average monthly level and the GoA does not "over-borrow" from the BCRA or Banco Nacion, FIEL believes that the BCRA can manage the gradual depreciation of the peso. FIEL estimates that the peso will end the year at about 3.80-3.90 ARP/USD. FIEL officials comment that even though the BCRA can manage the pace of the depreciation, it cannot avoid the consequence of its policy: a harder economic contraction than if it were to effect a large and rapid devaluation (increasing competitiveness and boosting fiscal revenues).

¶13. (SBU) FIEL's view on possible scenarios:

A) If the GoA increases expenditures 22%, the GoA will need to borrow about US$7 billion from BCRA reserves and/or from Banco Nacion.

B) If the political situation deteriorates and the GoA compensates by increasing expenditures 27%, it will need to borrow about $10 billion from the BCRA and Banco Nacion. Although this could raise concerns in the market and provoke deposit outflow and capital flight, FIEL still believes the BCRA would be able to manage a gradual depreciation of the peso under this scenario (and more easily under Scenario A).

C) In the extreme ("nothing to lose") case, where the current administration expects to perform poorly in the October elections, FIEL believes the GoA may go for BCRA reserves in a big way in order to finance efforts to build political support. FIEL officials consider this scenario unlikely, but note that it would provoke financial panic, major capital outflow, and an even sharper economic contraction. This March will be the turning point, according to FIEL, as the administration will begin to receive the results of early voter surveys.

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FISCAL
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Disappointing January primary fiscal surplus raises concerns on future performance
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¶14. (SBU) On February 19, the GoA reported that the GoA primary fiscal surplus fell 41% y-o-y, from ARP 3.4 billion in January 2008 to ARP 2 billion in January 2009, lower than private analysts' estimate of ARP 2.4 billion. This was the result of weak tax collection, which increased only 12% y-o-y, and higher expenditures, which increased 25% y-o-y. Within expenditures, transfers to the provinces increased 150% y-o-y to ARP 1 billion and infrastructure spending increased by 42% y-o-y to ARP 3 billion, while subsidies contracted 3% y-o-y to ARP 3 billion. (Subsidies in 2008 totaled ARP 31 billion.)



¶15. (SBU) The decline in the primary fiscal surplus would have been 82% when excluding the revenues derived from the nationalized private pension funds. After interest payments, the overall fiscal surplus for January was ARP 1.0 billion. (This compares to a fiscal surplus of ARP 2.4 billion in January 2008.) Private analysts estimate the 2009 primary surplus at about 1.7-2.0% of GDP, compared to the 2008 primary fiscal surplus of 3.1% of GDP, and also much lower

than the unrealistic 2009 budget estimate of a 3.27%/GDP primary fiscal surplus. The risk is to the downside, with the lower-than-expected January tax revenues and increasing fragility of the economy spurring many analysts to consider lowering their 2009 forecasts.

Provincial Fiscal Accounts deteriorate in 2008; worse expected in 2009
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¶16. (SBU) Economia y Regiones (ER), a local think-tank specializing in provincial issues, estimates that the 2008 provincial financial balance would post a deficit of ARP 3 billion, compared to a deficit of ARP 700 million in 2007. (Provincial fiscal data is released with a large lag; the final annual data is often released well after the beginning of the first quarter of the following year.) ER predicts that the provincial primary fiscal balance (the balance before interest payments) will be negative in 2008 for the first time since 2003. They predict the primary deficit will reach ARP 140 million, compared to a primary fiscal surplus of ARP 1.7 billion in 2007. Another prominent Argentine consulting company, Delphos Investment, has announced even more pessimistic forecasts: an ARP 600 million primary fiscal deficit in 2008 and an ARP 3 billion or higher overall fiscal deficit.

¶17. (SBU) The deteriorated provincial fiscal performance in 2008 was mainly the result of two factors: 1) an average 24% increase in provincial civil service salaries, which explains almost two-thirds of the increase in expenditures; and 2) a deceleration in GoA automatic co-participation transfers (which represent on average almost 50% of provincial income) due to lower federal tax collection resulting from the slowdown in economic activity.

¶18. (SBU) The 2008 provincial fiscal result was not evenly distributed among provinces. Fourteen provinces likely ended the year with a financial surplus, four provinces will probably post a primary surplus but an overall deficit, while six provinces will post a primary and fiscal deficit. The laggards of this latter group are the Province and City of Buenos Aires, which jointly will post an ARP 2.1 billion primary deficit and an ARP 3.3 billion financial deficit in ¶2008. (In 2007, the combined provincial primary fiscal deficit was ARP 565 million and overall fiscal deficit was ARP 1.6 billion.)

¶19. (SBU) The private sector expects the provincial financial situation to deteriorate even further during 2009. Consulting company Abeceb.com predicts the provincial primary fiscal deficit in 2009 will be ARP 700 million and expects the fiscal deficit to jump to over ARP 4 billion. Even this is optimistic compared to Ecolatina's forecast of an overall fiscal deficit as high as ARP 12 billion in 2009, depending on the size of an expected nationwide increase in civil servant salaries.
WAYNE